1941

Recommendations for modification of the abnormality and reorganization sections of subchapter E of the Internal Revenue Code relating to excess profits taxes

American Institute of Accountants. Committee on Federal Taxation

Recommendations for Modification of the Abnormality and Reorganization Sections of Subchapter E of the Internal Revenue Code Relating to Excess Profits Taxes

Submitted by the

COMMITTEE ON FEDERAL TAXATION

AMERICAN INSTITUTE OF ACCOUNTANTS

February, 1941

AMERICAN INSTITUTE OF ACCOUNTANTS

13 East 41st St., New York

Recommendations for Modification of the Abnormality and Reorganization Sections of Subchapter E of the Internal Revenue Code Relating to Excess Profits Taxes

Submitted by

COMMITTEE ON FEDERAL TAXATION
AMERICAN INSTITUTE OF ACCOUNTANTS

We understand that consideration is now being given to modification of the relief sections (721–723) and the reorganization sections (Supplements A and B) of the excess-profits-tax provisions (subchapter E) of the Internal Revenue Code. Since that subchapter was enacted the members of the accounting profession have been called upon to determine for many taxpayers their exemptions or credits under the income and invested-capital methods and to estimate the current year excess-profits net income and tax thereon, in order to state the approximate liabilities in financial statements as well as in anticipation of the preparation of excess-profits-tax returns. As a result many of the difficulties, complications, and inequities of the present statute have come to our attention. It is our desire, therefore, to present to you our recommendations for the modification of the sections above referred to, such suggestions being made in the light of our recent experiences.

Summary of Recommendations

We summarize our principal recommendations as follows:

A. We suggest broadening the section with respect to abnormalities so that the treatment now provided for the classes of abnormal income specified also extend to all abnormal income, and that in adjusting abnormal income the following provisions be added:

PAGE

ABNORMALITIES AND THE RELIEF THEREOF (SEC. 721–723)

Generally speaking, abnormalities which result in an inequitable assessment of tax will develop in respect of

(1) Current year income
(2) Base-period income
(3) Investment capital

Abnormal situations, unless corrected, not only result in an inequitably high tax, thus distributing the tax burden unfairly but also create disturbing influences in our national economy. Any taxpayer called upon to pay abnormally high taxes, in comparison with taxes of competitors not so unfortunately situated, is seriously handicapped and the normal trend of business activity suffers accordingly.

While it may be desirable to avoid such a form of relief as was allowed in prior excess-profits-tax acts which permitted special assessment, that can be done only if proper provision be made for the relief of *all* inequitable situations. The difficulty with special assessment lay not in the abnormalities (covered in general terms) for which the statute granted relief, but in the fact that the method or manner of determining the relief was not related to the abnormality. Often the result was an assessment that was still too high, or perhaps too low, rather than a fair assessment. It must be recognized, however, that the special-assessment form of relief was broad enough to take care of all abnormal situations, and the result placed such taxpayers as were entitled to it in a position comparable with competitors. Furthermore, it was administered with fewer complications and difficulties than are likely to be experienced with relief provisions which require more specific adjustments.

The relief sections, which we favor in principle, should be broad enough to cover all possible abnormalities and provide a method that will relieve the abnormal situation in a manner that will make the resulting tax normal.

A. ABNORMALITIES WITH RESPECT TO CURRENT YEAR INCOME

The most serious abnormality that will result in a disproportionately high tax is that which results from the technical requirements of the statute dealing with the recognition of taxable income and the year in which it must be subjected to tax. Tax laws call for the recognition of income, computed annually, on a basis specified in the statute rather than in accordance with accepted accounting principles. This often requires that income be taxed in one particular year though it results from the activities or expenditures of a longer period of time, or is due to events which occurred in a prior tax year. Hence, true excess profits will not be reached unless income of that type be redistributed over or to the period to which allocable.

Section 721 as it now stands adequately covers such a situation to the extent that the income results from certain specified activities or business operations. It fails, however, to grant appropriate relief in the case of income not derived from the six specified sources. We urge, therefore, the enactment of a general provision for the reallocation or distribution of any abnormal income received in any year. Specifying particular types of abnormal income necessarily excludes from adjustment other types not mentioned.

Inasmuch as the adjustment can be (as now) predicated upon a showing that the receipt of the income is abnormal or that the amount thereof is grossly disproportionate in relation to amounts derived in preceding years, we see no reason why a general provision with such protective features should not be enacted. Accordingly, we suggest the adoption of a broad general provision along the lines of the suggested draft hereto annexed. To avoid any doubts regarding the types of income now specified, which might arise were they eliminated, they are included in full in our suggested draft. It is not intended that income (or tax) which may be abnormally high as a result of either high prices or an unusual expansion of business activities should be subject to adjustment, and we believe that the proposed section 721 annexed will not permit adjustment in such cases. If necessary, specific reservations to that effect can be added.

In considering this proposal for a substitute section 721, it will be observed that, in addition to broadening its application, several new ideas have been injected into it. These we regard as important. They should be included in the statute even if a broad general relief section of the type suggested be not enacted. They include the following:

(1) A limitation on the tax on income which may be attributable to a future year.
(2) A provision for adjusting only the net income after deducting direct costs and expenses, rather than gross income.
(3) A provision for reducing the abnormal net income by the income tax thereon.
(4) A provision to take care of situations wherein the taxpayer was not in existence for four preceding years.

(1) *The tax on income which may be attributable to a future year should be limited*

Inasmuch as the purpose of section 721 is to grant relief from taxes that would otherwise be payable under subchapter E, there should be included a provision limiting the tax on income attributable to a future year so that it will not exceed the tax that would have been payable without recourse to the relief section. The propriety of such treatment is already recognized with respect to income attributable to prior years. There is no more reason to tax income attributable to a future year at a rate in excess of what would be payable for the current year than there is to subject to a higher tax rate the income attributable to a prior year.

If such a limitation be not added the statute should be modified to make it at least optional, on the part of the taxpayer, to elect to defer income to a future year. As matters now stand the Commissioner of Internal Revenue seems to be free to require such a redistribution, even if it increases the tax, and can do that after later developments indicate a higher tax would be assessable. The speculation on future rates and tax brackets, if it must remain, should rest with the taxpayer.

(2) *The adjustment should be only for the net income after deducting direct costs and expenses, rather than gross income*

The statute as it now stands deals with gross income, yet in many cases the receipt of the gross income also involves a deduction for losses, expenses or costs directly related to the production of the gross income. As the adjustment is to relieve abnormalities, it should be with respect to the net amount of abnormal income because in the final analysis the tax is based on net income —not gross income. For example, if a taxpayer should recover a substantial amount as a result of prosecuting a claim, it is quite probable that there would also be paid or incurred during the same year a comparable legal fee or other costs related to the prosecution of the case. Eliminating the gross income without also eliminating the costs and expenses relating thereto would in some cases result in such a distortion of income that the result, after the adjustment under section 721, would be more abnormal (a tax sometimes still too high but more often too low) than if no adjustment were made. This would be particularly true with respect to income which might be attributable to a non-excess-profits-tax year, in which circumstances the income would not be subjected to excess-profits tax but the expenses and deductions attributable thereto would be deductible for excess-profits-tax purposes.

Accordingly, our suggestion involves a transfer or redistribution of abnormal *net* income rather than *gross* income, and in defining that term, provision is made for deducting from gross income the costs and expenses directly attributable thereto, or out of which the abnormal income arises. The adjustment is specifically limited to direct costs and expenses to avoid the necessity for or the disputes likely to arise in connection with the apportionment of ordinary and general overhead expenses.

(3) *The abnormal net income to be redistributed should be reduced by the income tax thereon*

Similarly, we believe that appropriate adjustment should be made to reduce the abnormal net income by the amount of income tax attributable thereto, which income tax is deductible in determining excess-profits net income. It is proper that income taxes should be deducted before reaching a result that is termed "excess profits," but it is going too far the other way to eliminate net income arising from some abnormal cause and still permit the deduction of the income tax thereon. Under such circumstances normal net income is improperly reduced by income tax not related to it.

Failure to provide for this adjustment would thus produce another abnormality. Similarly, when the abnormal income is transferred or redistributed to another year subject to excess-profits taxes, there would otherwise be included in the income of the other year the gross income without deduction of the appropriate tax thereon.

Accordingly, therefore, abnormal *net* income which is made the subject of adjustment in the suggested section 721 is the amount of the gross income less the direct costs and expenses, less also the income tax attributable to the income from the abnormal source.

(4) *Situations wherein the taxpayer was not in existence four preceding years should be covered*

In providing that the amount of current-year income must be compared with the amount of income from similar sources for the four previous years to determine whether the former is grossly disproportionate, no provision has been made for cases wherein the taxpayer was not in existence four previous years. Hence, the status of such a taxpayer is in doubt. To clarify this situation and to eliminate possible dispute in the future, it is suggested that in cases wherein the taxpayer was not in existence four previous years comparison should be made with such previous years as are available, so that, for example, if the taxpayer were in existence only two previous years a comparison should be with those two previous years only.

(5) *Change of accounting period*

It will be noted that in the suggested substitute section 721 there has been included no reference to abnormalities resulting from a change in accounting period. Though abnormal situations will result from a change of accounting period, particularly in the light of the provisions of section 711 relating to periods of less than twelve months, they are not caused by income being included in a taxable year rather than a different taxable year. It is suggested, therefore, that provision for the relief of this abnormality be eliminated from section 721, the general method and purpose of which is not applicable to the aforementioned situation.

When a taxpayer files a return for a short period, the income falls either within or without that short period, as do the deductions, in accordance with the nature of the items involved and in the taxable period in which they normally would fall. There is no duplication or shifting, as might be the case when a taxpayer changes its accounting method.

However, the statutory requirement that the short-period income be placed on an annual basis, which presumes that the monthly average income for the short period would be the same as the monthly average would be for income for a full twelve-month period, will result in a distorted and abnormally high tax if the short period covers seasonal operations or if by reason of the technicalities relating to deductions (such as numerous taxes which are technically deductible in full on one day) certain items really applicable to the short period are not deductible in the short period because, though annual, the year's deduction accrues on one day falling outside the short period. The opposite result, too low a tax, might also obtain if the short period covers the off season or deductions really applicable to a full year fall within the short period.

To relieve this abnormality and the inequity that is caused by the applicable provisions of the statute, it is suggested that the provisions of section 711 (a) (3) be modified in accordance with the recommendation made by this committee under date of October 14, 1940. That recommendation and an illustration of how it would work out, as set forth in the October 14, 1940, report, is annexed.

B. Some Additional Items Which Should Be Covered Specifically if a Broad, General Provision Is Not Adopted

No group can expect to anticipate all types of abnormalities which may develop with respect to present and future income. Hence, a statute which limits relief to specified classes or sources of income is certain to fail to cover all possibilities. That has led to our recommendation that a broad general provision be adopted. But if that should be not acceptable, then certain additional types of abnormal income, which have come to our attention, should be added to the present form of section 721. They are:

(1) Income resulting from the sale, distribution, or disposition, other than collection in the ordinary course of business, of instalment obligations.

(2) Advance rentals or bonuses received in connection with a lease, rental, license, or similar agreement covering a period of more than one year.

(3) Income such as interest, rental, royalties, etc., covering a period of more than one year which becomes taxable in one year either because of the use of the cash basis, because it is technically payable only when earned or was not accruable at the usual time because of uncertainty regarding its ultimate collection.

(4) Income resulting from the disposition of current assets (receivables, inventories, securities, etc.) by reason of an enforced reduction in the basis thereof on account of cancellation or retirement of indebtedness in connection with receiverships or under section 215.

(5) Income first received in the form of foreign currencies having no dollar value (hence not then taxable) because of present world conditions, blocked currencies, exchange restrictions, etc., which later becomes taxable when restrictions are lifted. This would not be covered by subparagraphs (a) relating to claims or (f) foreign dividends where the claim or dividend receivable has been liquidated by payment in foreign currency or property which has no present realizable dollar value.

(6) Sections 711 a (1) (c) and 711 a (2) (e) adequately cover the abnormal

income arising from the discharge or retirement of debt evidenced by the type of obligation therein referred to. However, this affords no relief to the taxpayer deriving taxable income through the cancellation, settlement, discharge, or retirement of other types of debt, but such taxpayers are equally entitled to relief. Such income should, therefore, be included in the provisions of section 721 or the provisions of section 711 a (1) (c) and 711 a (2) (e) should be broadened to embrace them.

(7) Income derived from the proceeds of life insurance when the same constitutes taxable income by reason of the policy having been acquired for value is abnormal and should be allocated to the years during which the premiums were paid in proportion to the amounts of the annual payments.

C. Abnormalities with Respect to Base-Period Income

Abnormalities with respect to base-period income may arise in five different ways, each of which should be appropriately covered by the statute, as follows:

(1) Through the deduction, during the base-period years, of abnormal expenses, losses, or other deductions.
(2) Through the nature of the business or industry in which the taxpayer was engaged, if it was generally subnormal during the base period or a substantial part of it.
(3) Through the nonrealization of income, eventually derived in a later year, from the business or activity of one or more of the base years, which income is not included in income of the base years.
(4) Because during all or part of the base period the business of the taxpayer was in a development phase.
(5) Because during part of the base period the business was operated as an individual proprietorship or partnership and under the present statute the earnings of the partnership or individual proprietorship are not recognized in computing the excess-profits credit.

The members of the American Institute of Accountants believe that unless proper provision for the relief of abnormal situations arising from any one or all of the above causes be granted, the statute will produce most inequitable results. Whether these be many or few is not material, for not even one taxpayer should be subjected to an inequitable tax because the statute fails to provide adequate relief for such a case. The fact that only a few taxpayers might suffer a particular hardship makes it more important that relief therefrom be afforded by the statute. If every taxpayer suffers alike then the result ceases to be inequitable; hence, there should be no failure to provide adequate relief merely because relatively few taxpayers would be concerned.

(1) *The deduction, during the base-period years, of abnormal expenses, losses, or other deductions*

Appropriate provision has been made for the adjustment of the base-period income in respect of several unusual or abnormal losses or expenses which were deducted in determining normal-tax net income or special class net income during base years. However, the particular paragraphs of the statute dealing with such adjustments require some clarification or enlargement, and several additional adjustments should be allowed.

(*a*) *Casualty Losses, etc.*

Section 711 (b) (1) (E) provides for the adjustment of losses sustained through casualties, etc., to the extent not compensated by insurance. It is not clear whether the adjustment is limited to losses on the taxpayer's own property or includes any losses or damages suffered by others for which the taxpayer was required to make payment.

The regulations recently promulgated are silent on this point. The subsection refers particularly to deductions under section 23 (f) of the Internal Revenue Code. As to reimbursement for damages sustained by the property or person of others it has never been important to determine what particular section permitted such deductions, and it is not clear whether they come under section 23 (f) or another section. However, whether the loss is the result of damage to the taxpayer's own property or to the person or property of others, including employees, the loss is nevertheless a loss sustained as the result of a casualty. We recommend, therefore, that subsection 711 (b) (1) (E) be clarified to make it certain that it embraces all such losses.

(*b*) *Losses Through Claims, etc.*

Section 711 (b) (1) (G) covers the adjustment of amounts "attributable to" claims, awards, judgments, etc. It is not clearly indicated whether this paragraph is intended to include only the amount of the award and any interest thereon or also other expenses relating thereto, such as attorney fees incurred in the litigation, and it does not cover expenses and fees incurred in successfully defending a claim that was not allowed. Successful defense, as a rule, is more expensive than an unsuccessful defense. In either event, the costs and attorneys' fees are just as abnormal as the amount of the claim or award itself, and we suggest that the statutory provisions be extended to cover specifically such items, including those incurred in a successful defense against any claim.

Furthermore, the language of the subsection referred to seems faulty or at least ambiguous with respect to the amount to be excluded. It provides for the exclusion of the deductions attributable to a claim, etc., if abnormal for the taxpayer to incur such liabilities or, if normally incurred, the amount was disproportionate to the amount in previous years. It would seem from this language that even if it is normal for the taxpayer to incur such losses and if the amount in the particular year is disproportionate, then the adjustment to be made would be for the full amount of claim rather than merely the disproportionate excess. Such an interpretation seems illogical and such an adjustment would not appear to be proper, yet it seems perfectly possible to make such an interpretation. This, because of the fact that the following subsection (H), which likewise refers to deductions which, though normally incurred, were incurred in an amount disproportionate to the deduction of prior years, provides that the amount of the adjustment is *only* for the disproportionate excess. The failure to state in subsection (G) that the adjustment should be for the disproportionate excess, as specifically provided in the following subsection (H), would support the interpretation that under subsection (G) the entire amount of the claim should be excluded as a deduction.

(*c*) *Intangible Drilling Costs*

With respect now to subsection 711 (b) (1) (H), it has been observed that the statute does not indicate clearly what amount is to be made the subject of adjustment in cases where part of the intangible drilling costs, etc., was charged to expense and part was capitalized. It is noted that the acertainment of whether or not the amount is disproportionate is dependent upon the amounts of the *liabilities incurred* rather than the *amount deducted as expense*. It will be recalled that intangible drilling costs have heretofore been regarded as elective items which the taxpayer could charge to expense or capitalize in accordance with whatever method may have been elected at the appropriate time. Hence, the use of the term "liability incurred" rather than "expense deducted" leads to the conclusion that the ascertainment of disproportionateness is to be based on the total amount of liabilities incurred for the purpose whether they were expensed or capitalized.

However, even though the liability incurred in a particular year may be disproportionate, a portion of the total may have been capitalized so that the expense *deduction* was not disproportionate. This interpretation can work two ways. For example, a taxpayer may have incurred in a base year a total liability of $400,000 and an average annual liability of $100,000 in the four previous years. Thus, so far as the liability incurred is concerned, the base year amount is disproportionate to the extent of $300,000, but if, of that $400,000 liability incurred in the base year, $300,000 was capitalized, then so far as income is concerned the $100,000 deducted was not disproportionate in relation to the amount deducted in prior years. It would seem that under such circumstances no adjustment should be allowable, but if disproportionateness is to be based on a comparison of liabilities incurred an adjustment could be claimed under the provisions of subsection (H).

On the other hand, if in a base year a liability of $400,000 was incurred and the liabilities incurred in the four previous years averaged $400,000 annually, of which only $100,000 was deducted, but the entire $400,000 was deducted in the base year, there would be no abnormality on the basis of liabilities incurred but there would be a serious abnormality on the basis of the amounts expensed. In such circumstances, an adjustment of the base-year income should, logically, be permitted, yet it would appear that under the terms of the statute it would not be allowable.

We suggest a clarification of this subsection in order to provide that the ascertainment of disproportionateness be based on the amount expensed rather than on the amount of the liabilities incurred.

(2) *Inventory losses*

One additional major item will, we believe, seriously distort the base-period averages of many taxpayers. We suggest provision be made for excluding the deduction for abnormal inventory losses which occurred as a result of very sharp declines in the prices of most basic commodities as well as many manufactured items in which the material cost is a major element. Many taxpayers reported abnormally low incomes, or even losses, in 1937 or 1938 on that account.

This condition grew out of the unusual conditions prevailing at that time, war scares and so forth, and to the extent that net taxable income was reduced as a result of such abnormal inventory losses, the result cannot be a fair indication of normal earning capacity. We urge therefore that there be added to the provisions of section 711 (b) (1) a further adjustment to provide for the exclusion of abnormal inventory loss deductions.

(3) *Income taxes*

Although the statute generally provides for excluding abnormal income or deductions in the base period and current years, the correction of such abnormalities in the manner provided may create an abnormality of another type, because the income-tax deduction is not adjusted. By providing for the deduction of income tax on a lesser net income than is used for excess-profits credits the average base-period income is overstated.

The same result also obtains when the current-year excess-profits net income is computed. This committee has suggested that in adjusting abnormalities in current-year income the abnormal net income be reduced by the income tax attributable thereto. We now suggest that the statute be amended to provide that the deduction for income taxes in the base period or current year be an amount equal to what would have been payable had the expenses, deductions, or income, which are excluded in computing excess-profits net income, also been excluded for normal income-tax purposes.

(4) *When the business or industry in which the taxpayer was engaged was generally subnormal during the base period or a substantial part of it*

Taxpayers engaged in some industries are at a serious disadvantage under the existing law as the particular base-period years specified in the statute embrace a period during which their industries operated at a subnormal level. This situation was brought out at the time of the hearings on the recently enacted second revenue act of 1940. Hence, we submit no extended discussion but repeat the suggestion previously made that taxpayers be given the option of selecting an earlier four-year period during which business conditions were normal or at least be permitted to select any three of the four base years now provided. The right to such an election can be predicated on a showing that the 1936–1939 period was subnormal, so as to make it a relief matter.

(5) *The nonrealization of income, eventually derived in a later year, from the business or activity of one or more of the base years, which income is not included in income of the base years*

One of the serious abnormal situations that has developed arises out of the fact that in many instances income which was really being earned during, and attributable to activities of, the base period was not derived, from a tax point of view, until after the close of the base period; hence, the base period includes all the expense but none of the income. Some relief may be obtained by excluding some of the expenses during the base years, but that is meaningless in the case of a taxpayer having no income from other sources, and even if the taxpayer had income from other sources a reasonably fair result would not be obtained if there were not included in the base period the income really attributable to it but not derived, from a tax point of view, until after it ended.

The illustration of the long-term contracting corporation reporting on a completed contract basis is in point. Assume, for example, a three-year contract covering 1938, 1939, and 1940 (and no other income or contracts during the same period). If it earned $300,000 profit, the entire amount falls into normal tax net income for 1940. Under section 721 a part, say two-thirds, of the income may be excluded for 1940 excess-profits-tax purposes. But though it really earned $100,000 during each of the years 1938 and 1939 it is allowed no income for those two years.

On the other hand, a contractor otherwise similarly circumstanced, but reporting income for tax purposes on a partial completion basis, also would report $100,000 for excess-profits-tax purposes in 1940, but would have $100,000 of earnings for each of the years 1938 and 1939 on which to base the excess-profits income credit.

Such an abnormality should be corrected.

According to the Senate finance committee report it was intended that any abnormal income collected during the excess-profits-tax years, but attributable to the base-period years, should be added to the base-period income, for the purpose of determining the credit. The law, however, does not clearly indicate that that should be done and the commissioner of Internal Revenue has provided in his regulations that the base-period income is not to be adjusted by and in respect of abnormal income attributable thereto but derived in later years.

In the interest of a more equitable law, we urge that the intention of the Senate as expressed in its report be carried out by an amendment to the statute.

It may be more appropriate to include this provision, or such amendments as may be necessary to accomplish the desired result, in section 711 of the Internal Revenue Code rather than in section 721.

(6) *When during all or part of the base period, the business of the taxpayer was in a development phase*

Another abnormality, for which no provision is made in the statute, involves corporations which were engaged in developing a business during the base period, so that for all or a portion of it the earnings derived are not fairly indicative of normal earning capacity. While provision is made for the elimination or exclusion of the deduction for expenses in connection with certain types of development or exploration work, that provides no relief for a taxpayer that had little or no income because of the fact that it was doing nothing but development work. Furthermore, it provides no relief for taxpayers engaged not in oil-well or mine development but in developing another type of business. These are also entitled to relief.

This abnormality is best illustrated by the case of a corporation that sets out, say in 1934, to establish and develop a new business. Such cases usually involve a trade-mark, name, or brand, or perhaps a patent covering the manufacture of the article. The development of such a business usually requires the creation of a public following, either retail consumer or industrial. In each case the education of the prospective purchasers becomes necessary and a period of years of little or no profit must be anticipated. In such circumstances one cannot single out any particular expense which might be made the subject of adjustment, though often advertising and similar expenses may be high in relation to sales, because in reality all the expenses and efforts of the corporation are devoted primarily to the development or educational phase of its activities. Expansion and development of operations is thus paramount and profits are secondary.

Eventually, perhaps, in 1937, 1938, or 1939 the business reaches a developed state and thereafter is on what may be termed a normal earnings basis. Under the present statute such a corporation would determine its average earnings by taking into account the results of operations during the development stage, when they were either a loss or very little income. Averaging such results with the results of one or two years of developed business and normal income produces a base income for the purpose of computing exemption that is abnormally low, and the result is abnormally high excess-profits taxes. Such a taxpayer would really be subjected to excess-profits tax on normal income.

To alleviate this hardship we urge that the relief sections provide that if a taxpayer can establish that during any portion of the base period it was engaged in developing a new business so that operating results for that period did not reflect normal earning capacity, the development portion of the base period should be excluded from the computation of the average base-period income and the credit be based on the average annual excess-profits net income earned during such portion of the base period as did not cover a period of development.

The foregoing will not afford relief to corporations that remained in the development stage throughout the base period, since none of the base years reflect normal earning capacity. As to these, some arbitrary formula must be applied and we suggest the allowance of a credit equal to a percentage of the current-year excess-profits net income, say 75 per cent, as a third alternative credit. Further study of the available statistics by the Treasury Department may indicate that some other rate, approximately the average-earnings credit, would be more equitable—both ways.

(7) *Cases involving the incorporation during the base period of a business carried on by an individual proprietorship or partnership*

Congressional discussion on the second revenue act of 1940 indicated that the provisions of section 722 were broad enough to cover the case of a taxpayer corporation succeeding to the business of an individual proprietorship or partnership during the base period (or later), wherein the "constructive" income for the period prior to incorporation would be considerably less than the actual earnings of the business either after incorporation or during the period of its unincorporated operations.

This abnormality arises mainly in cases of the smaller corporations, those in which the net income resulting from operations is attributable to a material extent to personal activities of the proprietors, and in such cases it is found that the exemption based on invested capital is relatively negligible and that the earnings basis only will provide a reasonable and fair exemption for excess-profits-tax purposes. Where a limited constructive income based on invested capital must be taken into account for part of the base period because the business was incorporated after January 1, 1936, or only the invested-capital method becomes available, as in the case of a business incorporated after January 1, 1940, the result is not only abnormal but places the taxpayer in a most disadvantageous competitive position in comparison with other corporations, engaged in the same line of business, which were fortunate enough to have been incorporated prior to January 1, 1936. Such corporations are permitted to deduct an exemption based on the true earning power of the business which is denied to the taxpayer incorporated after January 1, 1936.

Though the amounts may not be large they are of the greatest consequence to the taxpayers concerned and it is believed that the revenue involved in granting relief from such an inequitable situation would be of little consequence so far as government revenues are concerned.

Obviously, the simplest method of correcting the abnormality would be to recognize, in computing the income credit, the earnings of the unincorporated business prior to its incorporation. The place for correction might well be in Supplement A, thus placing predecessor unincorporated businesses in the same category as component corporations. In providing for this, however, the statute should require that there be deducted reasonable compensation for services rendered by the proprietors and federal income taxes that would have been payable on the resulting net income if the business had been that of a corporation.

D. Cases in Which Invested Capital Cannot Be Satisfactorily Determined

Section 723, intended to cover cases in which the invested capital cannot be satisfactorily ascertained in accordance with the statutory formula, fails utterly to accomplish the desired result.

The invested capital that can be computed under section 723 will be the same as it would be computed under section 718 except that (1) no distinction can be made between capital and surplus, so that if there should have accumulated an operating deficit, that deficit will, indirectly, be deducted from capital paid in and (2) the depletion deductions would not necessarily be based on cost. Section 113 of chapter I requires that with respect to the year 1932 and subsequent years the depletion deduction shall be on the percentage-of-income basis (if that method was used) rather than cost. In such cases the basis of assets owned at the beginning of the year would be reduced by percentage depletion, but if invested capital is computed under section 718 only cost depletion would be deducted.

The fundamental difficulty in determining invested capital is not overcome by section 723. That lies in the determination of the correct income-tax basis of the assets owned at the beginning of the first taxable year. If any difficulty is to be experienced in computing invested capital it will lie in ascertaining the correct income-tax basis of the assets and, if that cannot be determined for the purposes of section 718, it cannot be determined for the computation of invested capital under section 723.

Since the enactment of the second revenue act of 1940 the members of the American Institute of Accountants have been active in tracing back, for invested-capital purposes, acquisitions of assets as paid-in equity capital. It was thought that when the taxpayer (or a transferor) was in existence during the prior excess-profits-tax period (1917–1921), the invested capital and basis of assets were determined under the prior laws. However, a number of situations have been developed in which it was found that by reason of the absence (in 1917–1921) of the necessary data it was impossible to ascertain the value of property paid in as invested capital. In such cases the tax was computed under the provisions of sections 327 and 328. Generally speaking, those were the cases of corporations organized a number of years prior to 1917 wherein it was impossible to ascertain either the nature of the assets originally paid in for capital stock or the value thereof even if the nature were known.

Section 723 provides no relief for or any method of determining invested capital in such cases. The taxpayers now find that what could not be done twenty-two years ago, because of the then absence of data and records, must now be done.

There are also a number of cases in which invested capital was determined satisfactorily under the old excess-profits-tax laws but neither invested capital nor the basis of assets can be determined satisfactorily under the present law. That is because under the prior laws intangible assets acquired through the issuance of stock could be included in invested capital only to a limited extent, and if acquired as paid-in surplus could not be included at all. In many cases it was obvious that the intangible assets when acquired were worth more than the maximum amount (if any) that could be included in invested capital under the statutory limitations. Hence no attempt was made to ascertain what the intangible assets were really worth. It will now be impossible to determine, in a number of cases, the value of such intangible assets as of the date of acquisition.

Correction of this situation is not a matter of relief but merely an attempt to overcome the impossibility of complying with the statute. This can be accomplished only through some arbitrary adjustment. A taxpayer should not be penalized because thirty or more years ago valuations were not made in anticipation of the excess-profits-tax legislation of 1940, or because in the interim records which might have permitted making the necessary valuation were destroyed or lost.

Most of the cases in this category involve the acquisition of assets prior to 1913. Since 1913 and until the so-called reorganization sections became part of the law, ascertainment of the value of intangible assets was necessary for income-tax purposes. Furthermore, since that time taxpayers have reported taxable income so that the basis of valuation is probably available even if the valuations were not then made.

One method of adjustment in such instances might be to allow such taxpayers to include in invested capital the value at March 1, 1913, of any assets then owned which were paid in for stock or as surplus.

Another method which might give partial relief would be to recognize the par or stated value of securities or stock issued for such assets. While this method might result in some cases in allowing too high a value, and in other cases too low a value, it would at least provide some allowance in all cases.

A third, and perhaps the most equitable, solution would be to compute the tax under provisions similar to sections 327 and 328 of the prior excess-profits-tax laws. That method, however, for such limited situations, would involve a not inconsiderable administrative expense and from a revenue point of view it is doubted that the amount of tax that might be involved would compensate for the cost of administering such a provision and developing the administrative control and data that would be necessary for the determination of tax.

As a means of adjustment to provide a basis for compliance with the statute, we recommend the second method above outlined, namely, that the par or stated value of stock issued for assets be recognized in any case wherein it is not possible to ascertain the correct amount includible under section 718 or section 723.

E. Supplement A Relating to Base-Period Income

The application of the provisions of Supplement A to specific cases has produced some weird results which, it is believed, were neither anticipated nor intended. Furthermore, it is our understanding that this section was adopted in order to relieve some of the inequitable situations that would otherwise develop and thus tend to make unnecessary a form of relief similar to special assessment, yet we find that in some cases Supplement A produces the opposite result.

For the clarification or betterment of Supplement A we make these specific recommendations:

(1) It should be provided that Supplement A is intended to grant additional benefits not conferred by other sections of subchapter E and is not in lieu thereof.

(2) Provision should be made for including, in the determination of base-period average earnings, income derived by a partnership or individual proprietorship which was incorporated after the beginning of the base period.

(3) The income of a component brought into the determination of the taxpayer's average base-period income, when fiscal accounting periods differ, should be placed on a comparable basis by taking into account a proportion of the income of overlapping fiscal years of the component to coincide with the accounting period of the taxpayer.

(4) The law should permit the inclusion in the base-period income of the earnings of all components and the taxpayer for the entire four-year base period and should not provide either for the exclusion of the income of one or more components or of the taxpayer itself for any portion of the period.

(5) The application of the limitations under section 742 (d) should not be limited to acquisitions after December 31, 1939, or require 75 per cent stock ownership. On the contrary, a taxpayer should, at its option, be permitted to exclude the operating results of any predecessor or component.

(6) Section 742 (e) relating to intercompany dividends is unnecessary and should be eliminated.

(7) A taxpayer should be entitled to include its own or a component's constructive income for the period prior to incorporation, under circumstances that will not involve duplication.

(8) All foreign corporations should not be excluded.

(1) *It should be made clear that Supplement A is intended to grant additional benefits not conferred by other sections of subchapter E and is not in lieu thereof*

The opening paragraph of section 742 provides that the computation of the base-period income, as therein provided, shall be in lieu of the method prescribed by section 713. Thus, instead of being a relief section, it would appear that taxpayers coming within the definitions of section 740 are required to compute base-period income under the provisions of section 742 no matter how inequitably its provisions may affect them, even to the extent, as will be pointed out hereinafter, of preventing the use of a taxpayer's own substantial base-period earnings merely because of a transaction subsequently consummated which, in reality, did not in any way affect the base-period income or the normal earning capacity of the taxpayer corporation.

We urge, therefore, that taxpayers which are entitled to elect the income-credit method under section 713 be given the option of using that method, regardless of the application of section 742, so that such taxpayers will be entitled to at least the basic earned-income credit computed under section 713.

(2) *Provision should be made for including in the determination of base-period average earnings, income derived by a partnership or individual proprietorship which was incorporated after the beginning of the base period*

One of the serious defects of subchapter E, previously pointed out in connection with abnormalities and the relief thereof, is the failure to take into account the income of an individual proprietorship or partnership for the period prior to incorporation when the business was incorporated after the beginning of the base period. This is particularly unfortunate as it affects principally the smaller corporations. The larger businesses were incorporated years ago. Only some of the smaller businesses have been conducted in recent years on an unincorporated basis. Companies of that type are most likely to use the earnings-credit method, since income of such a corporation is, to a material extent, the result of the personal activities of the shareholders, or proprietors, rather than the use of substantial amounts of capital. Exemptions or credits based on invested capital, therefore, are apt to be very low and quite out of line with the normal earning capacity of the business, taking into consideration services rendered by the shareholders engaged in operating it.

When net income is subjected to excess-profits taxes, after a business is incorporated, the measure of normal earning capacity is no less because it was incorporated after the base period started than if it had been incorporated prior to the beginning of the base period. As the normal earning capacity of predecessor corporations is recognized for their successors, so also should the normal earning capacity of a business conducted on an unincorporated basis be recognized as the earning capacity of the successor incorporated business. Such a result does not obtain when the use of actual earnings is permitted only for the period of incorporation and, for the prior period, the taxpaper is limited to a return on capital which does not represent normal earning capacity.

As indicated in our discussion with respect to abnormalities, it seems better to correct this situation by permitting the inclusion, in the base-period average-earnings computation, of the earnings of the business prior to incorporation. This should be limited, of course, to nontaxable incorporations.

(3) *The income of a component brought into the determination of the taxpayer's average base-period income,*

when fiscal accounting periods differ, should be placed on a comparable basis by taking into account a proportion of the income of overlapping fiscal years of the component to coincide with the accounting period of the taxpayer

The effect of section 740 with respect to an acquiring corporation is to provide that the base period shall consist of exactly forty-eight months. Yet section 742, dealing with the inclusion of component corporations' incomes, permits inclusion of qualified component corporations' incomes only for fiscal periods ending with or within the base-period years of the acquiring corporation, including only the component's fiscal years beginning after December 31, 1935. When the fiscal years of the components and the acquiring corporation coincide, no difficulties arise. Serious difficulties do arise when the taxable years differ even when the acquiring corporation adopts the same fiscal accounting period as the component but was organized after January 1, 1940, and on a date other than the beginning of its fiscal year. In the latter case its four base years must be the forty-eight months immediately preceding the date on which it was organized.

Thus, for example, if a taxpayer using a calendar-year accounting basis acquired a qualified component using a November 30th fiscal-year basis no income of the component would be included in the 1936 calendar-year income of the taxpayer. The component's fiscal year ended November 30, 1936, began before January 1, 1936, and hence is excluded under section 742 (a) (2). The income for the fiscal years ended November 30, 1937, 1938, and 1939, would be added to the taxpayer's calendar-year income for 1937, 1938, and 1939, respectively. The component's income for December, 1939, would not be included, since it would not be part of a fiscal-year ending within a base-period year of the taxpayer. Thus only *three* years' income of the component is included in the computation, but the result must be divided by *four* to determine the annual average.

To overcome the many different complications which might arise, we suggest that the statute be amended to provide that the excess-profits net income of any component corporation be first determined in accordance with its particular taxable periods, and that such results be converted to the same accounting periods as the taxpayer corporation by the process of using the applicable portions of the component's overlapping fiscal-period incomes averaged on a monthly basis. Thus, for instance, if the taxpayer should be on a calendar-year basis and the component corporation on a fiscal-year basis ending June 30th, the income of the component would be determined under the provisions of section 711 for the fiscal years ended June 30, 1936, and June 30, 1937, and 6/12, or one-half, of the income of each of those fiscal years should be taken as the 1936 calendar-year income to be added to that of the taxpayer. Such modification would overcome and eliminate all of the difficulties that may grow out of the fact that the forty-eight-month period of the taxpayer does not coincide with the fiscal accounting periods of component corporations whose income must be drawn into the calculation. It would also complete the requirements of section 742 (f) (2), which now provides that in the case of a qualified component corporation, there shall be excluded the portion of its excess-profits net income which is attributable to any period prior to the beginning of the taxpayer's four-year base period. There is at present nothing in the statute to indicate whether the income prior to that basic date should be determined on a pro-rata basis, according to the number of months in the component corporation's fiscal period falling prior to the basic date, or should be based on actual earnings for that prior period—which may not be ascertainable.

(4) *The law should permit the inclusion in the base-period income of the earnings of all components and the taxpayer for the entire four-year base period, and should not provide either for the exclusion of the income of one or more components or of the taxpayer itself for any portion of the period*

Section 742 (f) produces the most incongruous results of all. It is fundamentally unsound to the extent that it excludes the income of either the taxpayer or a component corporation for portions of the base period. Under section 742 (f) if a taxpayer was not in existence at the beginning of its four-year base period, it can include its own income in determining its own exemption only from the date it became an acquiring corporation. Thus a taxpayer reporting on a calendar-year basis organized on July 1, 1936, and acquiring in December, 1939, another corporation under circumstances bringing it within the provisions of sections 740 to 742, would lose the benefit, so far as credits go, of its own earnings from July, 1936, to December, 1939, even though they were at the rate of a million dollars a year, and even though the substitute therefor, a component corporation's earnings, may be only a thousand dollars a year or perhaps nothing if the component corporation has been losing money during that period.

Worse still, if such a transaction should be consummated even now the taxpayer would lose the benefit of its own earnings throughout the entire base period, to say nothing of the constructive income to which it would be entitled for the period prior to July 1, 1936, when it was organized. That provision of the law will effectively stop any taxpayer corporation from herafter acquiring the business and assets of another corporation, on a reorganization basis, if that other corporation earned less excess-profits net income during the base period than did the taxpayer and the taxpayer desires to use the income-credit method.

A typical illustration of how this works out is the case of a taxpayer organized during the base period and using the earnings-credit method and now considering—or was until this situation developed—the acquisition, through a nontaxable reorganization, of the business and assets of another corporation which has been on a steady decline, losing money throughout the base period. Taking over the losing corporation would be a desirable step from the nation's point of view because it would keep going a business that otherwise might close down and throw its employees out of work. If the taxpayer should do so, however, it would lose its income credit, for it would be denied the right to use its own income as the basis for exemption, and the corporation it was considering taking over had no net income.

The situation would be almost as bad if the taxpayer had been organized prior to January 1, 1936, and so had a full four-year history of its own. It would then be required to reduce its own earnings by the substantial losses sustained by the corporation it was considering taking over. Thus it would have to pay twice to take over the business of the corporation that is on the decline—once, in consideration for the acquisition of the remaining assets, property, and business and, second, in the form of a reduced excess-profits credit, which would result from combining the loss of the component-to-be and the income of the taxpayer for the base years.

Similarly, absurd results grow out of the provisions of section 742 combined with section 740 (c) relating to qualified component corporations. Here the income of a component corporation that was not actually in existence at the beginning of the base period of the taxpayer is excluded. Thus, if Corporation A were in existence prior to January 1, 1936, and Corporation B were organized July 1, 1936, and they both report on a calendar-year basis, the income of each corporation would provide the basis for exemption from excess-profits tax for the base period and, in addition, Corporation B would be entitled to bring into its computations constructive income for the six months preceding its incorporation, July 1, 1936. Should these two corporations and the businesses be merged into A, say subsequent to January 1, 1940, the income of Corporation B would disappear as a basis for credit. Thus there is injected into our national economy a disturbing influence and an additional expense and cost that would grow out of what might otherwise be a very sound and desirable merger. This, despite the fact that the revenues of the government should benefit anyway to the extent that the merger of the two corporations would reduce the number of corporations by one and there would be but one series of brackets up to $500,000 to be deducted before the excess income became subject to the 50 per cent maximum excess-profits tax.

We urge then that all these complicated restrictions and limitations upon the inclusion in base-period earnings of the income of either an acquiring corporation or a component corporation, dependent upon when the several corporations involved were organized or became acquiring or component corporations, be eliminated and that it be provided that the appropriate excess-profits net income of all corporations or businesses that are merged as a result of transactions specified in section 740 be brought into the computation of base-period income. It is proper, and should be so provided in the statute, that the base-period income for the full four years be determined for each corporation constituting the now consolidated business, including for any period prior to incorporation a "constructive" income, and that the combined results of all such determinations should be regarded as the base-period net income of the taxpayer emerging as a result of the transaction.

(5) *The application of the limitations under section 742 (d) should not be limited to acquisitions after December 31, 1939, or require 75 per cent stock ownership. On the contrary, a taxpayer should, at its option, be permitted to exclude the operating results of any predecessor or component*

Equally unfortunate and inequitable in its results is the fact that the net results, regardless of what they may have been, of any corporation which is a qualified component corporation must be drawn into the computation. The effect of this is partially overcome by the provisions of section 742 (d), but the application of that subsection is limited to cases in which there was a community of stock ownership to the extent of 75 per cent on September 11, 1940.

This effect of the statute will definitely prevent the merger of a profitable corporation desiring to use the income-credit method by reason of profitable operations during the base period with any other corporation that sustained losses during any or all of the base-period years.

If a taxpayer should now take over, in a transaction covered by section 740, a corporation that has been on the decline or losing money during the base period, it should not be further penalized by being required to reduce its excess-profits credit. It is all in the interest of the government and of this country as a whole that strong corporations take over and sustain the weak and thus keep the facilities of the latter in operation and its employees at work. The fact that a successful corporation is willing to take over the assets and business of one that is on the decline, in the hope that it will be able profitably to operate the business and property of the weakened corporation, should not make it subject to a penalty in the form of additional excess-profits taxes.

If the transaction turns out successfully for the acquiring corporation and it is able to increase its profits by reason of taking over the other corporation, that in itself should increase the income subject to excess-profits taxes and the taxes payable thereon. The tax should not be further increased by a forced reduction of the income exemption of the taxpayer. To overcome this inequitable and business disturbing situation, we urge that the provisions of sections 740 to 742 be made not mandatory so far as the taxpayer is concerned and that the taxpayer be permitted, at its option, to exclude or fail to take into its base-period income computation the results of any component corporation.

(6) *Section 742 (e) relating to intercompany dividends is unnecessary and should be eliminated*

It seems clear that section 742 (e) must have been retained in error. There appears to be no reason to retain in the statute complicated sections dealing with the elimination of intercompany dividends when the very definition of excess-profits net income which is involved in section 742 requires that all dividends from domestic corporations, intercompany or otherwise, be first eliminated in the determination thereof.

(7) *A taxpayer should be entitled to include its own or a component's constructive income for the period prior to incorporation, under circumstances that will not involve duplication*

It is the purpose of the statute to endeavor to ascertain, so far as it can through a statutory formula, the normal earning capacity of every taxpayer, to the end that only earnings in excess of the normal shall be subjected to excess-profits tax under subchapter E. In pursuance of this purpose, in the case of corporations that were not in existence during the whole of the four-year base period, provision is made for including in the income computation a "constructive" income measured by an 8 per cent return on the invested capital. The invested capital is taken as of January 1, 1940, or the beginning of the first excess-profits-tax year. That of itself may produce an abnormal result because it fixes an arbitrary date.

Sections 740 to 742 accentuate the inequity to the extent that they fail to permit taking into account a "constructive" income when a component corporation or an acquiring corporation are both involved. For example, if Corporation T were organized January 1, 1938, operated its business for a year, and on January 1, 1939, acquired, on a basis making it an acquiring corporation, the business and assets of Corporation B which was in existence prior to January 1, 1936, Corporation T would then be entitled to include in its base-period income the earnings of Corporation B for the four-year period, its own earnings for 1939 but not 1938, and no "constructive" income for itself for the years 1936 and 1937. Yet the aggregate result would have to be divided by four. To illustrate the inequitable result, assume that Corporation T had invested capital on January 1, 1940, of $1,000,000 and earned during 1938–1939 eight per cent thereof or $80,000 a year. Standing alone, its average base-period earnings (constructive and actual) would provide a credit of 95 per cent of $80,000, or $76,000.

On the other hand, if on January 1, 1939, with $500,000 additional capital it acquired all the assets and business of Corporation B which earned $50,000 during each of the three years preceding 1939, and the B business likewise produced $50,000 in income during 1939, the base-period income exemption would amount to only $66,500 a year, yet entering the first excess-profits-tax year would be a combined business with a demonstrated earning capacity of $130,000 a year. Had the companies not merged $123,500 would have been the combined income exemption computing each one separately. By reason of the merger, the statute reduces the exemption to $66,500 despite the fact that only one $500,000 bracket would be available to the combined businesses ($1,000,000 would have been similarly available to the two separate corporations).

It is doubted that such a result was contemplated or intended. We urge, therefore, that constructive income of a taxpayer and/or its components be included in determining the average base-period income. To prevent duplication there should be excluded from the invested capital of Corporation T, for the purpose of computing "constructive" income, any part thereof that arose out of the transaction whereby it acquired component corporation B. Thus, in the illustration the constructive income would be based on $1,000,000—not the $1,500,000 actual capital of T on January 1, 1940.

(8) *All foreign corporations should not be excluded*

Section 744 excludes from Supplement A all foreign corporations, despite the fact that under the provisions of section 112 foreign corporations may be included. Supplement A, as far as it goes, is a natural complement to section 112 and there is no sound reason for excluding all foreign corporations from consideration under Supplement A.

The earnings of a predecessor foreign business become subject to excess-profits tax when owned by a domestic corporation just as do the earnings of a predecessor domestic corporation.

It is recommended, therefore, that a foreign corporation that was recognized as a corporation under the provisions of section 112 (i) of the Internal Revenue Code, or comparable provisions of prior revenue acts, be recognized under Supplements A and B.

F. Supplement B—Highest Bracket Amount and Invested Capital

Section 751

We understand that it is the express purpose of sections 718 and 719 as modified or limited by section 751 to perpetuate for invested-capital purposes, but without duplication, a predecessor's basis when properties were acquired in a nontaxable reorganization. But that is not the result of section 751. As an illustration, the following figures are taken from an actual case. Corporation A possessed properties having a net basis in its hands (after deducting its liabilities) of $35,000,000. Such assets and liabilities were transferred to Corporation T which then issued or paid to the shareholders of A the following:

Cash	$ 3,000,000
Bonds	10,000,000
A and B stock (no par)	500,000 shares
(Market value $35,000,000)	

The stockholders of A (transferor) owned 60 per cent of the outstanding stock of T (transferee) after the reorganization. They were taxable on the gain—but not in excess of the $3,000,000 cash—though how much gain was taxed is not known to the taxpayer. Corporation A was not taxable on any gain. Assuming for the moment that A's basis of the property ($35,000,000) is not to be increased by the cash (though logically it should be, since the transaction was potentially taxable to that extent), there remains then the question of the extent to which the property was paid in for stock. Several interpretations of section 751 seem possible. Even the regulations do not dispose of all doubts, though they seem to infer that (1) below is the correct interpretation.

(1) That the $35,000,000 basis be attributed wholly to the shares of stock and treated as equity capital under section 718 and the bonds disregarded as borrowed invested capital under section 719.
(2) That the $35,000,000 basis be reduced by the bonds ($10,000,000) and the balance of $25,000,000 taken as equity capital paid in for stock, the bonds being disregarded for the purpose of section 719.
(3) That the $35,000,000 be apportioned between the stock and bonds, presumably on a market-value basis (35/45 and 10/45 in this case), and the portion assignable to the stock (roughly $27,000,000) taken in as equity capital and the portion assignable to the bonds ($8,000,000) disregarded for borrowed invested-capital purposes.
(4) In either (2) or (3) above the acquisition of properties might be attributed in part to the cash—rather than to the stock or bonds. The basis of $35,000,000 would be reduced by $3,000,000 under interpretation (2), leaving only $22,000,000 as equity capital, or, under (3) the $35,000,000 basis would be apportioned to the cash, bonds, and stock on a value basis ($48,000,000 aggregate) and $25,500,000 (roughly) attributed to the stock. In each case the amount attributed to the bonds would be disregarded for invested-capital purposes.

None of the four possible applications of section 751 produces equitable results.

Under (1) above a true carry-forward of the $35,000,000 basis results and as to invested capital the transferee stands in the same position as the transferor. However, the interest on the bonds constitutes a deductible expense which would not have been available to the transferor without a reduction in capital.

Under (2) the basic equity-invested capital is reduced to the extent that it has been partially converted into debt, but the taxpayer is denied the right to include borrowed invested capital. Had transferor A merely recapitalized, as have some taxpayers, and converted capital stock into a bonded obligation, it would have been entitled to include 50 per cent of the bonded indebtedness as borrowed invested capital. Why should T be denied the same rights?

Interpretation (3) is open to the same objection as (2) in that T is denied a right granted all other taxpayers though it is mitigated somewhat to the extent that the equity-invested capital recognized is slightly larger. If, however, the transferor's basis amounted to more than the market value of the securities issued the opposite result would obtain and a loss of part of the equity paid-in capital (to the extent that more than par was assigned to the bonds) would be added to the inequity of being denied the right to borrowed invested capital.

Result (4) above is open to the objections to either (2) or (3) and in addition requires a reduction of basis to the extent of the cash paid, even though the transaction was taxable to that extent and such a reduction is not required by section 751 (a).

All four interpretations are open to the objection that if the bonds should be retired, say out of accumulated cash earnings, included in invested capital as such, the invested capital would be wholly or partly duplicated.

To meet these objections, clarify the meaning of section 751, and carry through the obvious intent which is to continue the transferor's basis so as to place the transferee in the same position as the transferor would have been had the reorganization not occurred, we suggest that the statute be amended to provide that the net basis as now determinable under section 751 (a) be reduced by the value of the bonds, the balance being treated as equity-invested capital, and that the bonds be recognized as borrowed capital includible under the provisions of section 719.

An alternative method, mentioned here but not recommended, would be to recognize the full net basis of the assets computed as in section 751 (a) as equity-invested capital, disregard the bonds for the purpose of section 719 and disallow, for the excess-profits net income computation, all the interest on such bonds. However, should such a method be adopted it should also be extended to any nontaxable recapitalization wherein bonded indebtedness is substituted for equity capital in order not to limit the application of the principle to reorganizations involving a transfer of property.

Respectfully submitted,

AMERICAN INSTITUTE OF ACCOUNTANTS COMMITTEE ON FEDERAL TAXATION

WALTER A. COOPER, *chairman*, New York
JOHN A. CONLIN, New Jersey
SAMUEL W. ESKEW, Kentucky
JOHN D. FILSON, Illinois
OSCAR MOSS, California
J. A. PHILLIPS, Texas
JACOB S. SEIDMAN, New York
CLARENCE L. TURNER, Pennsylvania

PROPOSED REVISION OF SECTION 721

Section 721—Abnormalities in income in taxable period.

(a) If there is includible in the excess-profits net income of the taxpayer for any taxable year any income of any type or from any source, including:

(1) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or
(2) Income constituting an amount payable under a contract the performance of which required more than twelve months; or
(3) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than twelve months; or
(4) In the case of a lessor of real property, amounts included in gross income for the taxable year by reason of the termination of the lease; or
(5) Dividends on stock of foreign corporations, except foreign personal-holding companies;

which, in the light of the taxpayer's business it is abnormal for the taxpayer to derive in any year or, if the taxpayer normally derives income of such type or from such source, the amount includible in the gross income of the taxable year is grossly disproportionate to the average gross income of the same type or from the same source (each considered separately) included in gross income for the four previous taxable years (or, if the taxpayer was not in existence four previous years, the period during which it was in existence) or if by reason of a change in the taxpayer's method of accounting any item of income is includible in gross income for the taxable year rather than for a different taxable year, the abnormal net income of such type or from such source attributable to any previous or future taxable year or years, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the secretary.

(b) The abnormal net income attributable to future years shall be excluded from excess-profits net income for the taxable year and the tax under this subchapter for the taxable year (in which the whole of such abnormal net income would, without regard to this section, be includible) shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion of such abnormal net income attributable to any other taxable year, and
(2) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year beginning after December 31, 1939, to which any

portion of the abnormal net income is attributable, computed as if an amount equal to such portion had been included in gross income for such previous taxable year.

(c) The portion of the abnormal net income attributable to any future taxable year shall be included in excess-profits net income for such taxable year, but the tax under this subchapter for such future taxable year shall not exceed the sum of:

(1) The tax under this subchapter for such future taxable year computed without the inclusion in excess-profits net income of the abnormal net income excluded from the net income under the provisions of this section for any previous year or years and attributable to such future taxable year and,
(2) The aggregate of the increase in the tax under this subchapter which would have resulted for each previous taxable year (from the excess-profits net income of which such abnormal net income was excluded) computed as if such abnormal net income had not been excluded from excess-profits net income for such previous year or years.

(d) For the purposes of this section the term "abnormal net income" means the amount of the abnormal gross income, described in subsection (a) minus

(1) Any direct costs or expenses, deducted in determining the normal-tax net income of the taxable year, which were paid or incurred for the purpose of deriving such gross income or through the expenditure of which such gross income was derived, and
(2) Such proportion of the amount described in section 711 (a) (1) (A) or section 711 (a) (2) (C) as the balance of abnormal gross income minus the direct costs and expenses described in (1) above bears to the excess-profits net income for the taxable year, computed without reference to this section.

Recommendation for Computation of Tax for Periods of Less Than Twelve Months

[From Report of October 14, 1940]

The provisions for the computation of excess-profits taxes for periods of less than twelve months should be revised to eliminate unjust hardship and the possibility of tax avoidance

The provisions of the recently enacted excess-profits-tax law with respect to the determination of excess-profits taxes for periods of less than twelve months will result in either an unjust hardship or tax avoidance. This matter is covered by subsection 711 (a) (3) which applies in cases where the taxable year is changed, so that for the period of the change a return for less than twelve months is required and in the case of newly organized corporations adopting a fiscal-year ending less than twelve months after organization. The requirement that the income be placed on an annual basis will produce an equitable and fair tax only if it be a fact that the income for the short period is ratably comparable with the earnings for a full year. Should such short-period earnings be in excess of the average rate per month, the tax will be excessive and unduly burdensome; should they be less, a way for avoidance of tax is open.

During recent years there has been a definite tendency and trend on the part of business in general to adopt fiscal years that coincide with the natural business year, instead of the calendar year. This change has been fostered, not only by the accounting profession, but by business organizations generally, and particularly the Securities and Exchange Commission, which supports the use of a natural business year in the interest of providing security holders and prospective investors with the more informative statements and earnings reports that the use of the natural business year for accounting purposes makes possible.

Many businesses are seasonal, and when changes in fiscal years are made the income for the short period is usually considerably in excess of a ratable portion of the year's earnings because the proper fiscal year should end with the active business season; thus including, as a general rule, the profitable period of operations. A typical illustration is that of a corporation operating a business, the season for which ends in midspring, say May 31st, and all the income of such a corporation will be derived from operations during the first five months of the year. During the remainder of the calendar year, the corporation may be lucky to "break even," particularly as during the last few months of the calendar year it is likely to be incurring substantial expenses in the nature of getting ready for the next year's seasonal operations. To illustrate the effect of section 711 (a) (3) as proposed, assume the case of a corporation engaged in such a business and earning during the five months ended May 31st a net income for excess-profits-tax purposes of $66,000. Assume further that it has an invested capital of $500,000 upon which it is entitled to an exemption rate of 8 per cent. Such a corporation may earn little or nothing during the remaining seven months of the year, and for this illustration we assume that the remaining seven months produce neither net gain nor loss. If it continued for the full calendar year, its tax, on the figures given, would amount to $4,250, but under the provisions of section 711 (a) (3), if it should change to a natural business year, ending May 31st, it would be required to pay a tax of $13,178. A law that produces such a result is most inequitable. Conversely, if the income for the short period should be less than the annual average, too low a tax will be payable.

To remedy this, we suggest that the law be modified to provide that in the case of a period of less than twelve months there be added to the income for the short period the income for the remainder of the full-twelve-months' period, taking the months immediately following the end of the short period; that the tax be computed on the basis of that twelve-months' income, and that the amount payable for the short period be such proportion of the tax on the twelve-months' income as the amount of the income for the short period is of the income for the twelve-months' period.

If the income for the short period be the same as for the year, the full tax thus determined should be payable and, if the income for the short period be greater (because a net loss was sustained during the balance of the year), there should be payable an excess-profits tax, computed at the same average rate on the larger short-period income as results from the full year computation.

The following is a summary of the excess-profits tax that would be payable under this proposal compared with what would be payable under the existing law in the case of a corporation changing to a fiscal year ended May 31st, earning during that period $66,000 on an average invested capital of $500,000, and assuming operating results for the remaining seven months as shown below:

	Operating results for the remaining seven months	Excess-profits tax under existing law	Excess-profits tax under proposed amendment
(A)	No gain or loss (Year's net $66,000)	$13,178	$4,250
(B)	Profit of $11,000 (Year's net $77,000)	13,178	6,000
(C)	Loss of $6,000 (Year's net $60,000)	13,178	3,300

Such a change would present no complications and would not reduce revenues, but, if anything, is likely to increase revenues. Obviously, a corporation that would be required to pay an excessive tax, under the proposed law, would not change its fiscal year; while one that might pay a lesser tax, under the law now proposed, would request permission to make such a change. On the other hand the continuance of the present provision will probably stop completely the very desirable trend of business corporations towards the use of a natural business year for accounting and other purposes.